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Entrepreneurship in the Russian Service Sector: Trends and Developments

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Abstract: In a market economy, the service sector across many industries is driven by entrepreneurship translating into powerful driving forces of motivation and competition (creative destruction). Under the post-Soviet transition the service sector in Russia is one of the most dynamic sectors of the national economy. There are strong indications of positive entrepreneurial developments in such segments of the service sector as construction and home improvement, real estate, wholesale and retail trade, banking, insurance, hospitality, tourism, and other industries. The paper identifies current patterns and trends, motivations and obstacles for entrepreneurship in the Russian service sector. It focuses on high propriety sub sectors in the service sector that are highly attractive for entrepreneurs and factors making those sub sectors particularly attractive; geographic, demographic and other factors affecting demand for services; major obstacles in the service sector affiliated with entrepreneurial business venture start-ups; key governance and support factors on the part of local and federal government; and finally common patterns of decision making in entrepreneurial business venture start-ups.

Keywords: Russia, entrepreneurship, service, trends, business start-up

JEL Classification: L800, L260

Introduction

Economic growth and development in many advanced nations around the world are increasingly dependent on the service sector often contributing 65-75% to the overall economic wealth. With ‘smoke stack’ industries gradually relocating to less developed nations their economic role in advanced countries tends to diminish. The service sector becomes particularly important since many nations strive to move up

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the value creation chain in their effort to operate in the knowledge-based industries. Typical examples include software development, imaging, entertainment, and communications to name a few. In addition and beyond economic forces driving entrepreneurial developments there are also strong impacts of service-oriented culture and entrepreneurial tradition. A share of the GDP generated by the Russian service sector in 2006 was 55.8% compared to 69.1% in Germany, 69.2% in Italy, 73% in Japan, 77.2% in France, and 78.2% in the USA (CIA, 2007).

Historically, small business has been a relatively self-contained economic activity focused on local markets and needs. Its capital has been limited, and the owner and manager have often been one and the same. Such enterprises have been operating in market segments that have not been served by big corporations. They paid taxes, did not need large-scale government support, and have had limited cooperation with each other.

Today small and medium enterprises (SMEs) play an increasingly important institutional role in developed economies since their significant contributions to both economic welfare/ development and employment due to their high adaptability to local conditions, independent decision-making process, quick and flexible response to market changes, and low start-up capital requirements. Neace (1999) observes that ‘Long-term success in economic development, particularly in developing economies, depends to a significant degree on a growing network of small entrepreneurial enterprises . . . and human capital in the person of an entrepreneur.’ Their contribution is not just economic, as Neace also stresses the role of entrepreneurs as agents for creating social capital in emerging economies.

Besides that, the SME’s fundamental role in economic development stems from cushioning the impacts of structural reforms by providing alternative employment and - especially important in Russia’s case – because it ‘helps to reduce an emerging market economy’s vulnerability to external shocks by providing a domestic engine for growth’ (Economist Intelligence Unit, 2004). Financial dislocations and collapses of the 1990s and extremely poor legal environment in Russia did not allow for any meaningful growth of SMEs in service industry until deregulation started in 2001.

By 2005 Russia’s GDP in real terms reached almost 90% of the pre-reform level of 1990. But this fact conceals wide variations across sectors and regions. Value added in manufacturing was less than 70% of the Soviet maximum. The oil and gas sector reached its pre-reform level of output. And services — trade, transport, communications, and finance—exceeded it.

Currently, under the second stage of the post-Soviet transition the service sector in Russia is one of the most dynamic sectors of the national economy, next to the oil and gas extraction. While there are some recent trends pointing out to the rebirth of government capitalism and increased state control over the Russian economy, there

are also strong indications of positive entrepreneurial developments in the service sector in such fields as construction and home improvement, real estate, wholesale and retail trade, banking, insurance, hospitality, tourism, and other industries.

As of recently, Russian economic growth has been primarily driven by the production of non-tradable services and goods for the domestic market. The 2006 was marked by the continuing trend in the high growth of the construction and retail trade sectors. In January - October 2006, compared to January - October 2005, this growth constituted 13.2% in the construction sector, 12.5% in retail trade, and 2.5% in transport. In contrast, these indicators for the same time period were 1.3% for agriculture, 2.2% for extraction of mineral resources, 4.7% for manufacturing and 5.1 for electricity, gas, water production and distribution (Russian Economic Report, 2006).

Roots and Prevalent Types of Russian SMEs

Russia's entrepreneurial potential stems from vast supplies of natural resources and a well-educated population. Ageev, Gratchev & Hisrich (1995) see Russian entrepreneurship: 'on the leading edge of radical economic and political transformation of the society that should lead to new business developments, and improved quality of life'.

Traditional fields of small business activity are small-scale and individual production of goods, retail trade, hotel and food services, construction, transportation, and health care. As Khodov (2003) notes, 'this is the first type of small enterprises, a necessary step in the initial accumulation of capital and spread of market relations'. The distinctive features of this group of SMEs are as follows: their business is typically based on accumulated family capital; it depends primarily on local resources and focuses on local markets; and there is no capital diversification into other industries/types of activity or other regions. This category of SMEs was completely destroyed in Soviet Russia in the course of socialist transformation followed the 1917 Bolshevik Revolution and replaced by local industry and consumer cooperatives. Khodov argues that 'the resurrection of local independent business is slow and difficult, not only because of the shortage of capital and low solvent demand in the Russian countryside but also because of the lack of acceptance of the concept of entrepreneurship by the social consciousness, which is stuck in traditional and socialist ideas of equalization in distribution'. The existence of this type of SMEs is subject to local natural conditions (local types of agricultural production and natural resources like climate, recreational areas etc.), consumer preferences, and traditional local specialization in the nationwide context. The prospects for the development of these types of enterprises depend on the growth of

the local population's purchasing power and the development of tourism. As the pattern of the local population's consumer needs and consumption changes, the composition of local small business also changes.

Another type of small and medium-sized business is the suppliers of parts and services for large enterprises. This type has been facilitated under the Soviet Union economic framework with its centrally planned economy where industries and large enterprises of high national strategic priorities have been planned and managed on the federal level whereas SMEs serving some of their needs have been under local jurisdiction and management. The development of this type of business in the post-Soviet period in the 2000s is fostered by new forms of commerce, especially franchising. In Russia, such enterprises are not numerous so far but obviously have huge potential, as the robust growth and increase in the efficiency of the domestic economy require a deeper division of labor and broad development of consumer services both in range and scale.

Priority Subsectors

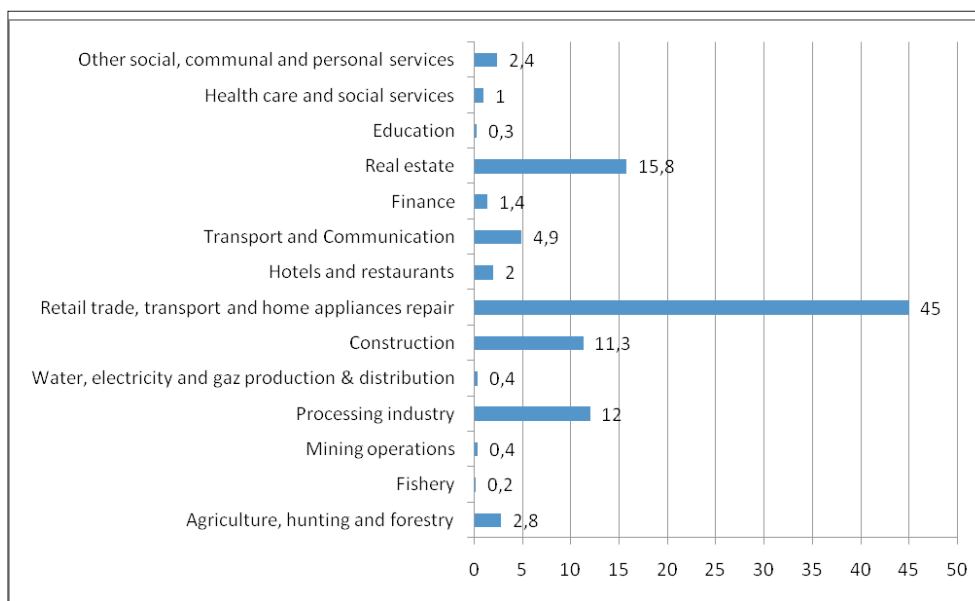
The Russian Federal Service of State Statistics (FSSS) reports that there are 7.2 SMEs per a thousand of population in Russia (FSSS, 2008), while in some European Union countries this figure is significantly higher - close to 45, 49.6 - in Japan and 74.2 in the U.S. In total, by the end of year 2006 there were almost 1 million small businesses in Russia.¹ More than 50% of the SMEs are located in the Central and North-Western federal districts, among them 25% are located in the capital city of Moscow. Small business is still underdeveloped in the Far Eastern (4.8%), Ural (6.7%) and Southern federal districts (9.7%). About 46% of all small business enterprises in Russia operate in wholesale and retail trade and food service, about 11% - in construction service and about 14% - in production industries. Figure 1 shows detailed breakdown of SME by industries.

The latest Global Entrepreneurship Monitor (GEM, 2006) survey that covered 42 countries worldwide suggests modest level of entrepreneurial development in Russia (Table 1 provides key comparisons of entrepreneurial activities in Russia with other countries).

It is reasonable to expect that in an economy with severe deficit of consumer goods and services like the post-Soviet economy of Russia a booming growth of entrepreneurial activity would take place particularly in retail trade and service industries.

In a contemporary Russia, the primary users of various services are middle age well-paid professionals from 30 to 44 years old, followed by young employees from 25 to 29 years old.

Figure 1: Distribution of SME in Russia in 2006, % of the total number of SMEs.



Source: Federal Service on State Statistics, 2008

Table 1: Prevalence Rates of Entrepreneurial Activities: Russia versus Other Countries

	Nascent Entrepreneurial Activity	New Business Owners	Early-Stage Entrepreneurial Activities	Established Business Owners
Russia	3.5%	1.7%	4.9%	1.2%
China	6.7%	10.5%	16.2%	9.0%
Germany	2.9%	1.7%	4.2%	3.0%
Italy	2.2%	1.4%	3.5%	3.0%
Japan	1.6%	1.4%	2.9%	4.8%
USA	7.5%	3.3%	10.0%	5.4%

Source: Global Entrepreneurial Monitor, 2006

As most service sectors are still undeveloped and are in dire need of advanced expertise Russian consumers often have high regard for Western service quality, brand name and often choose a service from a Western provider or provider with a Western service component. At the same time there is a growing awareness among

Russian entrepreneurs that service industry has a strong potential as well as growing demand from Russian consumers for locally produced and branded services.

Russian service industry related newspapers like 'Economics and Life' and 'Financial Newspaper,' as well as professional service industry magazines like 'Services and Prices,' 'Tourism: Practice, Problems and Perspectives,' 'Restaurant News,' 'Hotel,' point out to the following service subsectors that are in high demand and thus most attractive from a business development standpoint:

- consumer services (barber shops, house cleaning/renovation, baby sitters, courier service, etc.);
- food services (full service, fast-food, catering, food delivery, and take-out services in restaurants);
- financial services (leasing of equipment and insurance);
- health care;
- advertising;
- accommodation (hotels, motels, vacation houses, resorts);
- entertainment (aqua-parks, amusement parks, bowling/snooker clubs, night clubs, sport centers, etc.);
- tourism (travel agencies, tour operating, excursion bureaus, local sightseeing);
- educational/training services;
- information and telecommunication services (internet providers, computer services, cable TV, VoIP).

It is necessary to mention that in Russia consumer services and entertainment are the only two subsectors in the service industry where the market share of SMEs is dominant mainly due to short payback periods.

Recent Legislative Initiatives and Reforms in the SME Sector

During Vladimir Putin's first term as President numerous laws have been adopted to improve the business climate in Russia, particularly to ease the start-up and operating conditions of SMEs. Legislation has been introduced to streamline the number and extent of inspection procedures that firms are subject to, the licensing of various economic activities, the taxation of small firms and the registration of new businesses. Legislative reforms have facilitated improvements in SME practices, but not as great or as steady as they should have been.

Russia's tax system was overhauled in 2001, with a view of simplifying it and easing the fiscal burden on companies and individuals. The corporate tax standard rate is currently stands at 24% (reduced from 35% in 2001). It is comprised of a 17%

regional tax, 5% federal tax and 2% local tax. That corporate income tax favorably contrasts with China's 33%, Germany's average 38.3%, Italy's 33%, Japan's 30%, and US' 35% (Worldwide-tax.com, 2008).

Another reform that has had positive impact was the introduction of a simplified tax regime for SMEs in July 2002. SME growth, especially in the service sector, has been significantly restrained by the tax burden that the government had imposed on them. Since 2002, firms with fewer than 100 employees and a turnover of under 15 million rubles² can choose between paying the less onerous of two taxes: either a 15% flat tax on profits, or a 6% flat tax on turnover (compared to the 24% profit tax imposed on larger firms). Eligible firms are also exempt from VAT, sales tax, property tax and payroll tax. A survey conducted by the Moscow-based Center for Economic and Financial Research (CEFIR) has found that firms that had switched to the new small-business tax regime on average considered it a real improvement on the standard taxation arrangements³ (Economist Intelligence Unit, 2004).

A 'one-stop shop' approach to business registrations was introduced by the Ministry of Economic Development and Trade in 2002.

According to the CEFIR survey, licensing used to be a big problem, and has been identified by SMEs as the main obstacle to small enterprise growth in Russia before 2004 when the number of commercial activities requiring a license was significantly reduced.

To facilitate and support SME innovations the Foundation for Assistance to Small Innovative Enterprises (FASIE) was created in 1994 by the Russian government. The funding provided by the government comprises 1.5% of the total federal expenditures for non-defense related R&D. FASIE supports small innovative companies through open competition. Proposals for financial support prepared by innovative companies are submitted to peer review by external reviewers from the science and business sectors (including representatives of banks and venture and investment funds). FASIE's financial share in the winning projects cannot exceed 50%, and the companies retain their rights to their intellectual property created in the projects. FASIE provides support only to projects included in a list of government-approved critical technologies.

As illustrated by Bortnik (2004), in the late 1990s, FASIE has began increasing its support for companies at the seed and start-up stages, obviously a riskier strategy. The change was stimulated not only by stabilization of the general economic situation but also by the fact that the FASIE's financial resources have been growing larger. In addition, repayment of the FASIE's earlier loans has stabilized and provided additional funds. In 2003, FASIE initiated a program called START to support start-up companies. About half of the FASIE's budget has since been devoted to the START program (from \$10 million when the FASIE was started in 2003 to approximately \$15 million in 2006). In its composition and instruments the

program resembles the American SBIR program. The first results show that about 20% of supported firms managed to find investors and thus get FASIE's funding for the second year. Although \$15 millions is a very limited amount for SME funding in such a large economy as Russia, this is a rather encouraging result showing that there are quite a few technology-intensive goods and services created by SMEs with high commercial potential.

The Russian government continues its effort in strengthening and creating new initiatives to support innovative and commercially promising developments in smaller firms. Such measures include more effective infrastructure (technology parks, incubators), centers that offer specialized services, and financial support for small firms and start-ups.

Obstacles in SME Start-ups and Operation

In the late 1990s, starting-up and operating SMEs in Russia have been prone to the following major obstacles in the service sector (in descending order of importance):

- taxation system that restrains growth of the business (more than 40 different taxes and obligatory payments to be met by small businesses totaling up to 90% of company's profit);
- lack of finance and credit facilities (because of high interest rates, an unrealistically high collateral requirement and a lack of long-term financing availability);
- state credit lines requirements (legal need of support by federal budget of small businesses' requirements for external funding, obligation to collateralize up to 50% - 70% of the total project value, and maximum project duration and repayment term limited to two years);
- impoverishment of the population severely limiting effective demand;
- obsolete equipment and limited availability of new one for small-scale production;
- lack of knowledge about economics, management and business procedures;
- lack of insurance services for small business;
- bureaucracy and administrative barriers (red-tape);
- corruption and racket;
- lack of incentives for long-term business (Polonsky, 1998).

As already mentioned, due to numerous legislative initiatives many of these problems have been solved, but some of them are still in place and even have worsened.

Table 2: World Bank Rating of Doing Business in Russia for 2007 and 2008

Ease of...	Doing Business 2008 rank	Doing Business 2007 rank
Doing Business (overall)	106	112
1. Starting a Business	50	45
2. Dealing with Licenses	177	172
3. Employing Workers	101	102
4. Registering Property	45	44
5. Getting Credit	84	156
6. Protecting Investors	83	81
7. Paying Taxes	130	126
8. Trading Across Borders	155	155
9. Enforcing Contracts	19	19
10. Closing a Business	80	81

Notes: (1) Ratings are given out of 178 countries ranked in the order of descending ease of doing business in a country. (2) Doing Business 2007 rankings have been recalculated to reflect changes to the methodology and the addition of new countries.

Source: The World Bank Group, 2007

The latest World Bank data on doing business in Russia (World Bank Group, 2007) presented in Table 2 provide good illustration of the recent changes. Under the World Bank methodology all rankings and values are calculated for a limited liability company located in the peripheral urban area of the country's most populous city. The company is 100% domestically and privately owned and has 50 employees all of whom are nationals. This methodology is completely suitable for our analysis but allows for detection of some significant changes in the business environment.

As follows from Table 2 Russia's overall rank in the World Bank survey improved from 112 in 2007 to 106 in 2008. The most dramatic improvement in the World Bank ranking for Russia comes in the 'getting credit' category where Russia's ranking improved by 75 positions from # 156 in 2007 to # 84 in 2008. In the 'Employing Workers' and 'Closing Business' Russia's ranks improved by one in each category. While there were no change in the ranking for the 'Trading Across Borders' and 'Enforcing Contracts' categories, unfortunately a number of Russia's rankings worsened: 'Starting a Business' and 'Dealing with Licenses' by 5 ranking points each, 'Paying Taxes' by 4 points and 'Registering Property' by 1 point. These rankings reflect overall positive changes in the SME legal environment and other

improvements. Although paying taxes is still a complicated issue according to the World Bank, it is not a case for SMEs in the service sector that usually employs no more than 10-15 persons. Difficulty of dealing with the licenses can be explained by complicated and unclear procedure of getting license for those types of business that require a license, but after 2004 their overall number has decreased. Comparing Russia with the region suggests that for the majority of the World Bank survey indicators Russia's performance is similar with the region or better. The detailed breakdown of the World Bank data is shown in Appendix 1.

The World Bank data on doing business still does not include ranking of business transparency where Russia's situation remains problematic. According to the Business Monitor International's (2007) Transparency International survey Russia's record on transparency remains poor. Its world rank in 2007 was 143/179 with a score of 2.3 (International Corruption Perceptions Index - CPI - ranges between 10 – highly clean to 0 – highly corrupt⁴). Russia's 2007 ranking actually drastically worsened compared with 2006 when it was 121/163.

Decision-Making Patterns in SMEs

The majority of small business people in Russia have never received any formal business education. Some of them have gained their experience while working in the informal (underground) economy and still often rely on the same well-tested practices. There is an obvious need for business education that to certain extent is fulfilled by business courses and seminars offered in major cities by governmental and private educational institutions. Business education is becoming more popular, although its need is still sometimes acknowledged out of politeness or political correctness rather than in real belief. Russian economic reality is full of examples where success has no correlation with business education.

An earlier conducted survey (OECD, 2003) reported that 52% of small business directors attended business seminars, particularly for training in bookkeeping and taxation. The survey respondents reported that the factors preventing them from undertaking training included lack of money (1/3 of respondents) and unwillingness by management to release people from work (1/6 of respondents). Entrepreneurs in the service industry have been facing a problem of finding qualified personnel when starting up a new enterprise during the past five years, suggesting that there may be a growing demand for training.

At the same time it is noticeable that Russian entrepreneurs are quick learners. For example, a few years ago some common concepts of the international hospitality industry like 'international operator,' 'royalty fee,' 'management contract' etc. were not clear to Russian operators and partners; today they are able to deal with

international management companies and learn how to manage international mergers and acquisitions (Antel, 2006). In major cities (Moscow, Saint-Petersburg, Novosibirsk, Yekaterinburg) a new trend appears: young (under 30) generation of entrepreneurs expresses strong demand for business education, eager to invest time and money, and often combines professional full or part-time education with distant business education.

To illustrate some patterns of decision-making in entrepreneurship in the service industry it is necessary to provide background information explaining the attitude of the Russian society towards employed in service industry. In the Soviet Union the service industry was neglected for political reasons, and consequently it was difficult for the sector to attract a high-quality workforce. As a result, even now service sector entrepreneurs and employees are sometimes regarded as 'either mafiosi or as incompetents who do not have the necessary intellect for more prestigious careers' (Jallat, Shekshnya, 2000). The service industry was among the first to benefit from economic liberalization. Unsatisfied and inexperienced thus unexacting customer was ready to get almost any kind of service offered. Besides that, people from pensioners to government officials shared the same opinion that creating and running a service business was a simple task that did not require specific skills, preparatory work such as marketing research or value chain planning, or previous experience. All those circumstances negatively affected the level of quality of services and the entire entrepreneurial climate in the service industry. Jallat and Shekshnya (2000) identified five categories of entrepreneurs in the service sector in the Post-Communist Russia, as shown in Table 3.

Despite of a change in mentality, many people consider working in the service sector to be on a par with being a servant with a sort of derogatory connotation attached. Still there is some lack of quality consulting services for small businesses in the service sector, especially those focusing on local markets afar from large cities. Under the rising consumer power and growing experience the demand for knowledge and practical skills in such issues as service delivery design, customer complaint handling, service quality, analysis of customer needs and so forth is to be taken into account on common basis. So far the Federal Government also has not gotten to a point of concern with the provision of consulting services and instead often prefers to rely on 'heavy' methods like credits and subsidies in steering small businesses in the desired direction, while some local governments, like in Moscow and St. -Petersburg, started providing information and sometimes business consulting services to potential entrepreneurs in specific fields which are particularly important for the cities.

Table 3: First Categories of Service Entrepreneurs in the Post-Communist Russia

Categories	Origin of Business	Sector
1. Former managers of State-owned companies	Privatization of existing organizations	Retail trade, banking, public catering, hospitality
2. Former 'cooperators'	Cooperatives turned into private companies Acquisition of existing organizations	Retail trade, public catering, education, software development
3. 'Deal genius'	Creation of new structures	Wholesale trade, banking, finance
4. Professionals	Expansion of individual activities into a business	Software development, education, consulting, medical care
5. Soviet era entrepreneurs/ black market masters	Legalization of underground businesses Acquisition of existing organizations Creation of new structures	All

Source: Jallat, Shekshnya, 2000.

Another pattern of SME decision-making process that has been identified in interviews with entrepreneurs in the service industry is that even in regions where small business is well developed, small business people are not among major consumers of specialized information services (databases and online consultancies on various aspects of small business start-ups and operations). This area remains unnoticed by governmental agencies responsible for the development of small business and is not financially attractive by large commercial providers. Only in Moscow the situation is different, where local government supports about 40 web sites with information tailored to small business.

A specific aspect of Russian entrepreneurship in the service sector is the growing number of female entrepreneurs (Wells, Pfantz, Bryne, 2003). In fact, 60% of female entrepreneurs in Russia are in the service sectors (that includes business services, finance, insurance, real estate). Although over half of them draw financing from private sources such as personal savings, friends and family, and 92% of them have rated capital availability as a problem, female entrepreneurs respondents demonstrate striking optimism: 42% expressed an optimistic or a very optimistic outlook of the Russian economy for the next few years and 58% expressed an optimistic or a very optimistic outlook for their own business.

SMEs in the Service Sector in Moscow

Russian government's development plans for tourism identify Moscow, the Moscow region, St. Petersburg, Kaliningrad and the so called 'Golden Ring' cities as major tourism centers and priorities for development. Investment in the development and modernization of the tourism infrastructure is considered the backbone of the future market growth. Domestic tourism will be increasingly emerging as the basis for tourism development and is expected to increase its share in the overall tourism revenue.

The growth of sales at Russian cafés and restaurants has averaged about 8% a year since 2000. The restaurant business in Moscow is one of the fastest-growing segments of the city's rapidly expanding economy. A growing middle class is creating a solid customer base, with the result that numerous restaurants and cafes are opening or expanding, and purchasing equipment and supplies. Over the last ten years the number of food service companies in Moscow has almost doubled and today reaches some 10,000 enterprises with total capacity of almost 700,000 seats. Coffee shops have seen some of the fastest growth, expanding in excess of 20% per year.

As communicated by the Minister of the Moscow government responsible for the development of consumer goods and services, professor of the Plekhanov Russian Academy of Economics Vladimir Malyshkov, Moscow government supports small business in the following ways: provision of credit on favorable terms, granting subsidies, subventions and guarantees of small business loans to financial institutions, joint financing, leasing of equipment at convenient terms, and establishing attractive rental rates. There are more than 20 governmental agencies and designated organizations in Moscow that support small business. For example, the Financial Assistance Foundation established by the Department of Consumer Goods and Services of the Moscow Government in 2005 provided financial help to the following small business recipients in their first or second year of operation (Malyshkov, 2006):

- 43 retail trade companies - for about 5.5 million rubles (US \$ 200,000);
- 18 food service companies - for about 2.5 million rubles (US \$ 90,000);
- 44 consumer service companies - for about 6 million rubles (US \$ 215,000).

As for the accommodation subsector in services, the Moscow city government considers switching an emphasis from the development of four- and five-star hotels to building a network of medium-class hotels to cater for guests with average incomes. The city is planning to build up to 40 two- and three-star hotels in the next

decade in order to boost the incoming tourism. It is expected that small business entrepreneurs will be interested in the development of the small budget hotels.

The least developed subsector of the service industry in Moscow as well as in Russia as a whole is consumer services (hair/beauty salons, tailoring, laundry, repair workshops, photo studios, cleaning service, etc.) It can be explained by lack of support and governance in earlier years when free market forces pushed out or completely destroyed such services due to their low profitability. Currently, there are about 7,000 companies providing consumer services but customers often complain both about lack of these services and their poor quality. It has forced the Moscow Government to develop and start implementation of a special program to facilitate priority growth of this subsector in 2007-2008. Being a capital city, Moscow often creates a pattern that is followed by other large Russian cities if it proves successful.

Conclusion

As the Russian fledging service sector is gaining momentum in contributing to the nation's economic wealth and dynamics in the post-Soviet transformation its share in the nation's GDP remains relatively modest at 55.8%. That compares to 69.1% in Germany, 73% in Japan, and 78.2% in the USA, leaving significant room for growth.

Over half of SMEs are located in the Central and North-Western part of Russia with Moscow and St. Petersburg remaining major hubs; remote areas located in the Far Eastern, Ural and Southern federal districts continue to be underdeveloped. Above 46% of all SMEs in Russia operate in the wholesale and retail trade and food services, about 11% - in construction and about 14% - in manufacturing industries.

Legislative and administrative reforms over the past few years have streamlined and improved situation in taxation, registration, financing and other crucial components closing the gap in SME environment between Russia and other countries. Meanwhile, many problems, such as restraining taxation system, limited SME access to financing, low consumer spending power among general population, lack of SME training, non availability of business services and other problems, remain.

The stage of 'wild business' in the post-Soviet transformation appears to have passed and now entrepreneurs as well as the society as a whole increasingly need transparent rules and business relations in business transactions and the overall business environment. Macro-economic environment as well as government efforts in streamlining legal environment contribute to the continuing increase in entrepreneurial potential of the Russian service sector.

With consumer spending as a primary growth driver in the current economic development Russian service providers continue to benefit from high demand and

robust customer confidence. Despite some decline in purchasing power, because of the weak dollar, from those employees whose salaries are nominated in US dollars, the Russian consumer remains unsatisfied while both real disposable income to keep rising and substantial consumer credit expansion taking hold.

Although a lack of support of the Federal Government to SME's 'soft' issues still remains in place, many local governments, especially those in capital cities, adopted special programs in assistance and support of SME start-ups, and the service sector is among top government priorities.

The growth in entrepreneurial activity along with other positive trends in Russia's service sector is expected to continue suggesting positive future outlook in this sector translating in improvements in volume, range and quality of services.

NOTES

¹ Throughout the 1990s – 2000s, the universal definition of SMEs in Russia has undergone several changes. In terms of economic dimensions, the latest law divides all enterprises in the economy into two categories: small enterprises and large and medium enterprises. Small enterprises are classified by the Federal Law 'On the State Support of Small Business in Russian Federation' # 88-FZ of 14 June 1995 into three groups: individual entrepreneurs without legal status, farm enterprises, and small enterprises – legal entities. The Law determines small enterprises - legal entities as having: no more than 25% of the state, municipal, public and religious organizations or charitable funds' ownership in their charter capital and not exceeding the following limits in annual number of employees: 100 persons in industry, construction and transportation, 60 in agriculture and R&D areas. Russian law does not define a specific category of medium-sized enterprises

² The exchange rate as of January 27, 2008 was 1.00 USD= 24.4990 RUB; or 1 RUB = 0.04081 USD (Universal Currency Converter, 2008)

³ Some experts point out that small and individual enterprises in Russia have not become the engines of a healthy economy. Instead of fostering growing companies Russia has fostered the creation of a vast number of very small businesses comprising the 'kiosk economy.' This 'kiosk economy' of micro businesses employs a quarter of the population but comprises a disproportionately small share of GDP and the tax base. Other than providing employment, these businesses add little to overall wealth creation and the majority of them are unlikely to make the transition to mid-size businesses because it will require massive advances in business education, regulatory environment, court system, financing, and other components of the business infrastructure. The current Russian legislation and regulations press small business to be very small. In drafting the small business legislation the government decided to offer tax breaks and a friendlier business environment only to those companies that it considered as economically less significant for the budget. Thanks to government reforms, small enterprises are now easy to start and accounting requirements as well as taxes are minimal. While this is a great step forward it has not led to a critical growth of medium enterprises because of the low cut-off limit for use of the simplified system of taxation and the abrupt and hugely punitive cost of moving to the regular tax system. Small businesses that do well under the protection of the simplified system of taxation are often not large and strong enough to survive the full weight of Russian taxation and accounting requirements. Many businesses that grow too large to use the simplified system find that they do not have sufficient resources to thrive without it and find their growth stunted. Additionally, the burdens of compliance and

making advance tax payments are often more destructive to growth than the actual increased taxes themselves (Firestone, 2005).

⁴ In contrast, the #1 Denmark had a 9.4 CPI score.

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Appendix 1: World Bank Rating of Doing Business in Russia 2008 breakdown

Aggregated Index	Indicators	Russia	Region	OECD
Starting a Business	Procedures (number)	8	8.8	6
	Duration (days)	29	26.2	14.9
	Cost (% GNI per capita)	3.7	11.1	5.1
	Paid in Min. Capital (% of GNI per capita)	3.2	45.3	32.5
Dealing with Licenses	Procedures (number)	54	24	14
	Duration (days)	704	251.3	153.3
	Cost (% of income per capita)	3788.4	628.4	62.2
Employing Workers	Difficulty of Hiring Index	33	36.3	25.2
	Rigidity of Hours Index	60	51.4	39.2
	Difficulty of Firing Index	40	32.1	27.9
	Rigidity of Employment Index	44	40.0	30.8
	Nonwage labor cost (% of salary)	31	25.4	20.7
	Firing costs (weeks of wages)	17	26.1	25.7
Registering Property	Procedures (number)	6	6.2	4.9
	Duration (days)	52	92.4	28.0
	Cost (% of property value)	0.3	2.4	4.6
Getting Credit	Legal Rights Index	3	5.6	6.4
	Credit Information Index	4	3.4	4.8
	Public registry coverage (% adults)	0.0	2.4	8.6
	Private bureau coverage (% adults)	4.4	15.4	59.3
Protecting Investors	Disclosure Index	6	4.9	6.4
	Director Liability Index	2	3.8	5.1
	Shareholder Suits Index	7	6.3	6.5
	Investor Protection Index	5.0	5.0	6.0

Paying Taxes	Payments (number)	22	46.3	15.1
	Time (hours)	448	451.5	183.3
	Profit tax (%)	14.0	11.2	20.0
	Labor tax and contributions (%)	31.8	28.7	22.8
	Other taxes (%)	5.7	10.8	3.4
	Total tax rate (% profit)	51.4	50.8	46.2
Trading Across Borders	Documents for export (number)	8	7.0	4.5
	Time for export (days)	36	29.3	9.8
	Cost to export (US\$ per container)	2050	1,393.4	905.0
	Documents for import (number)	13	8.3	5.0
	Time for import (days)	36	30.8	10.4
	Cost to import (US\$ per container)	2050	1,551.4	986.1
Enforcing Contracts	Procedures (number)	37	35.9	31.3
	Duration (days)	281	443.0	443.3
	Cost (% of claim)	13.4	22.7	17.7
Closing a Business	Time (years)	3.8	3.2	1.3
	Cost (% of estate)	9	13.7	7.5
	Recovery rate (cents on the dollar)	29.0	28.9	74.1

Note: (1) Ratings are given out of 178 countries in order of decreased ease of doing business in a country. Source: The World Bank Group, 2007